No. 13116.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PALOS VERDES CORPORATION, a Corporation,

Plaintiff-Appellant,

vs.

UNITED STATES OF AMERICA,

Defendant-Appellee.

APPELLANT'S OPENING BRIEF.

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Jurisdiction.

(Numerals in Brackets refer to Pages of Record.)

This is an action for refund of income taxes arising under the Revenue Code of the United States, 26 U. S. C. A. Int. Rev. Code, Sec. 117. The action was commenced by the filing by plaintiff-appellant, Palos Verdes Corporation, herein at times referred to as the "Corporation" on April 11, 1951, of a complaint for refund of income tax against The United States of America [3 to 14, inclusive].

Harry C. Westover, the Collector of Internal Revenue, 6th District of California, to whom the income tax herein

involved was paid in his official capacity as such Collector was not in office at the time of filing this action [17].

Said action was authorized against the United States of America as party defendant, 28 U. S. C. A., Sec. 1346(a)(1).

On December 15, 1944, the Corporation filed with the Collector of Internal Revenue, 6th District of California, the corporation income tax and declared value excess profits tax return for the period commencing October 1, 1943, and ending September 30, 1944, and paid to said Collector the sum of $17,066.36 [17]. Thereafter the Corporation filed its claim for refund in the amount of $5,467.88, with said Collector, Harry C. Westover, on March 9, 1945 [17], and the Corporation again filed its claim for refund with said Collector, Harry C. Westover, on October 30, 1946, in said same amount, to-wit, $5,467.88 [18].

Said claims for refund were duly and timely filed. 26 U. S. C. A., Sec. 322(b).

By letter to the Corporation dated August 4, 1949, the Commissioner of Internal Revenue of the United States disallowed said claim for refund [18].

Said action for refund of income tax was timely and properly brought. 26 U. S. C. A., Sec. 3772(a)(1)(2).

Defendant, United States of America (herein at times referred to as "Government") filed its answer to said

complaint [14 to 16, inclusive], and the trial of said action was held on May 2, 1951 [60]. By its minute order dated May 3, 1951 [60], the Court entered an order that judgment be for the defendant.

Findings of Fact and Conclusions of Law were filed July 10, 1951 [60 to 69, inclusive]. Judgment was made and filed July 10, 1951 [69, 70].

Notice of appeal by the plaintiff was filed on July 28, 1951 [71], under the provisions of Fed. Rules Civ. Proc., Rule 73. Plaintiff filed its Designation of Record on Appeal on August 16, 1951 [71, 72]. The defendant filed its Counter Designation of Contents of the Record on Appeal on August 22, 1951 [73].

On August 29, 1951, a Motion for Order, and Order Extending Time for Filing Record on Appeal and Docketing Appeal was made and filed [74, 75].

On October 23, 1951, plaintiff-appellant filed its Statement of Points on Which Appellant Intends to Rely Upon Appeal to the United States Court of Appeals, 9th Circuit [186, 187, 188].

This Court has jurisdiction to review the judgment of the United States District Court in this matter under the provisions of 28 U. S. C. A., Sections 1291 and 1294.

Statement of the Case.

Plaintiff-appellant is a corporation organized November 27, 1925, under the laws of the State of Delaware with its principal office and place of business located in the city of Wilmington, County of Newcastle, State of Delaware [18]. Since 1926 the Corporation has transacted and is doing business in the County of Los Angeles, State of California [18]. The Corporation took over from Palos Verdes Syndicate as of January 1, 1926, approximately 12,245 acres of land in the County of Los Angeles, State of California, with other assets, giving in exchange therefore 54,000 shares of its common stock, having an aggregate par value of $5,400,000 issued pro rata to the members of the Syndicate as their interests appeared [18]. Said land was and is known as "Rancho Palos Verdes" [18]. Said Rancho Palos Verdes originally comprised approximately 16,004 acres of unimproved real property in the County of Los Angeles [82]. It was acquired by a group of persons known as the Palos Verdes Syndicate in the year 1913 [63]. After acquisition, the Palos Verdes Syndicate appointed a General Manager to operate and manage the ranch, and it engaged in farming activities [81]. After holding the land for a period of ten years, the Palos Verdes Syndicate decided to sell the whole parcel and entered into an agreement to sell in the year 1923 [83]. The whole sale was not consummated by reason of the fact that the purchaser was unable to raise sufficient moneys to buy the whole Rancho [105]. Two portions of the Rancho were actually sold, to-wit, 3,000 acres in the northerly and westerly edge of the Rancho and 200 acres on the southerly and easterly edges of the Rancho [83]. Then this land was deeded to the Bank of Italy, in trust,

for subdivision and development purposes [84]. Said portions were later subdivided, developed and handled by the Bank of Italy and became known as "Palos Verdes Estates" and "Miraleste," respectively [84]. Neither the Palos Verdes Corporation nor the Palos Verdes Syndicate had any further interest therein from the date of sale [83].

After the formation of the Corporation, there were no changes in its activities, and it continued to hold the real property and to engage in farming activities as its predecessor in interest, Palos Verdes Syndicate, had done before [86]. A General Manager was appointed who made contacts with farmers, share croppers and for some cash farming rentals and looked after the payment of taxes and matters relating to the valuation of the land by the Assessors [86].

The affairs of the Corporation were handled by a managing Vice President [106]. The Vice President and General Manager rendered annual reports for the benefit of the Board of Directors and the stockholders on his stewardship [114, 115, 141]. Statements made by him in the annual reports were matters to be considered by the Board of Directors and did not necessarily reflect policy of the Corporation as such [142]. Said annual reports in parts indicated that the only financial solution for the Corporation was to sell its lands as farming was unprofitable; that the land was becoming exhausted from farming and mineral extraction [135]; that its lands were valued so high for taxation purposes [129] that it was unprofitable from a farming standpoint [125]; that the taxes were greater than its farm income [135]; and that the future of the Corporation lies in the development and sale of its real estate [130,

131, 135]. The recommendations that the future of the Corporation lies in the development of its real estate was not acted upon, as no subdivision, development and improvement of the acreage lands was undertaken by the Corporation [95, 147, 171, 172] (outside the Rolling Hills development).

The reasons for the formation of the plaintiff-appellant Corporation were that Palos Verdes Syndicate was a very loose form of holding title to the real property and was not satisfactory in connection with the administration thereof [85]. Since the formation of the Palos Verdes Syndicate one or more of the original members had died, and estates were involved, and it was thought desirable to change the form of ownership to that of a Corporation [85, 86]. At the time of the hearing of this action, all members of the original Palos Verdes Syndicate were dead, except one who is very aged and outside the State of California [79, 80].

The Corporation, from its inception, endeavored to sell all its real property, substantially in the same condition in which it had acquired it [97, 143, 145, 179]. Although the Corporation endeavored to sell all of its real property in a single sale, it failed to do so [173, 178]. Although the Corporation considered the subdivision and development of the whole Rancho this was never done [139]. In a number of years no sales were made, and in some years only one sale was made [168]. Many sales in acreage were made to persons who, in turn, subdivided and developed and sold the property acquired from the Corporation [160, 168].

None of the acreage parcels sold by the Corporation were improved prior to the sale or for the purposes of sale [95]. The acreage sold was not platted on any

subdivision map prior to sale [147, 171]. At the time of sale in each instance, the parcel sold was thereupon surveyed by metes and bounds and was delineated and described [95, 147]. These sales resulted substantially from the activities of the General Manager, who had a real estate broker's license and who was paid a commission on all sales made by the Corporation [97, 107, 172]. Some sales were made by independent brokers, who were also paid a commission [108]. Interested persons who desired to acquire real property made inquiries of the Corporation [95]. If their offers to purchase were satisfactory, the Corporation would sell such portions as it deemed suitable [170, 171]. No "For Sale" signs were ever authorized to be put on the acreage parcels of the Rancho [95, 172, 173], and there were no real estate offices built or located on the Rancho, other than in the "Rolling Hills" subdivision area [96, 173]. The Corporation employed no outside real estate brokers for the sales of acreage [96]. The property was not listed with independent brokers, and no prices were fixed in advance on the land, except for the proposed single sale of the whole to the United States Government in 1944 [95].

In making such sales of acreage it was the policy of the Corporation to hold the main body of the Rancho intact for a single sale [173]. When, under financial pressure, sales were made of portions of the Rancho around the periphery in so far as possible, in order that such sales would not hurt the proposed ultimate sale of the main body of the Rancho [173]. Except for the Rolling Hills Subdivision, the only improvements which were made by the Corporation in connection with the Rancho, were the installation of certain paved roads for use in connection with its farming operations [95,

162, 163], and the installation of a water system which was used for irrigation purposes in connection with its farming activities [163]. The first time Corporation actually plotted, subdivided, developed and improved for the purposes of sale any portion of the Rancho was in or about the year 1936, and this constituted the Rolling Hills subdivision [106].

Prior to the actual subdivision of this parcel within the meaning of the State and County law, the Corporation sold portions of this Rolling Hills section as acreage for residential purposes [106, 107].

The Corporation had in use a map which it called a "Crop Map" which delineated the arable and tillable portions of the Rancho, and this was used by the Corporation in its farming activities [147, 148]. Approximately 40% of the Rancho, constituting substantially all of the arable and tillable portions of the Rancho, were farmed by the Corporation since 1926 [164]. The Corporation endeavored to make the maximum use of its lands for farming purposes [164].

In the month of July, 1944, the Corporation sold to one Snow an unsubdivided portion of [its] real property in the County of Los Angeles, State of California, for the sum of $90,000.00, consisting of 422.56 acres [18]. Said real property has a cost base to the Corporation in the sum of $23,636.93, resulting in a profit or gain of $66,363.07. During the fiscal year of the Corporation, commencing October 1, 1943, and ending September 30, 1944, the Corporation received from said Snow, on account of said purchase price of $90,000.00, the sum of $27,000.00 and elected, pursuant to Sec. 44(b) of the Int. Rev. Code to report, for income tax purposes, said sale upon the installment basis [19].

Said real property sold to Snow was acquired by the Corporation as part of said 12,245 acres of land transferred to the Corporation as of January 1, 1926, in exchange for its common stock [19]. Said real property had been owned and held by the Corporation since said date, to-wit, January 1, 1926 [19].

Said Snow lived in the neighborhood of Rancho Palos Verdes and told an independent broker that he would like some of the land of the Corporation [173, 174]. The broker thereupon came to the General Manager of the Corporation at that time and inquired concerning what land was available for sale [174]. An offer was made to the Corporation which was deemed acceptable by it, and the real property was then sold to Snow [174]. The land which was sold to Snow had been used by the Corporation in connection with its farming and grazing activities [174]. Income was derived from this parcel in the years prior to and during the year of sale [45]. At the time of the sale the tillable portions of said real property were under a crop-sharing lease, dated October 1, 1943, with one Harold M. Thorsen, for a term beginning on that date, and ending September 30, 1944 [175]. The other portions of the parcel which were not suitable for agricultural purposes were in use by the Corporation for sheep grazing and income was being derived by the Corporation for such use [177, 178]. The only improvement on said land was the existing road known as Palos Verdes Drive East, which traversed approximately the center of the parcel [155], which road was put in by the Palos Verdes Syndicate approximately in the year 1924 [164]. Other than the road, the real property was in the same condition as when acquired by the Palos Verdes Syndicate in 1913 and transferred to the Corporation in 1926 [162, 164]. Said land was not part of the Rolling Hills Sub-

division, was not platted or subdivided or delineated prior to the sale [147]. At the time of the sale the Corporation employed a civil engineer to survey and delineate and describe the area sold [147]. The property sold to Snow was later used by him for subdivision purposes [160].

The Corporation caused to be distributed to the public. certain leaflets or brochures describing the land it held [108, 109]; part of these brochures were confined to that section known as Rolling Hills subdivision [109], while other leaflets described the balance of the unsubdivided property of plaintiff known as acreage [Deft. Exs. A, A-1, A-2, A-3, A-4]. Leaflets and brochures relating to the whole Rancho were distributed not earlier than the year 1937 [109]. In one year, 1940, postcards were mailed to the public in Los Angeles, offering to sell land at $185.00 per acre [114]. These cards referred to certain lands on the northern periphery of the Rancho, which was in the main not arable, but was rough, barren and non-producing, and was substantially untillable and not suitable for the farming activities of the Corporation [143, 144].

Between 1941 and 1944, the Corporation made varied and vigorous efforts to dispose of substantially all of its real estate holdings, to various agencies of the State and Federal Government, and caused to be made a plat showing the area laid out for park purposes [144, 145].

The Corporation sold, during the fiscal year ended September 30, 1944, both subdivided land and unsubdivided portions of the property, and the sales of its unsubdivided portions greatly exceeded in number the subdivision sales [46]. During the fiscal year, ending September 30, 1944, the Corporation in addition to the Snow Sale made 34 other sales of unsubdivided land, totaling 531.850 acres [46], and reported these sales as ordinary income [27].

The Corporation claimed and asserted at the time of the hearing of this action that, in addition to the real property sold to Snow, the other acreage parcels sold during the fiscal year ending September 30, 1944, should be treated as the sales of capital assets; but an error was made and the claim for refund which was filed should have included all of the acreage sales as sales of capital assets [179].

The Corporation, from its inception, derived substantial income from its farm and pasture rentals, crop sales and earth and rock royalties [45, 87]. In the fiscal year ended September 30, 1944, it derived an aggregate income from such sources in the sum of $138,711.76 [45]. The income derived from farming operations and from rock and earth royalties, however, was insufficient to pay the expenses of the Rancho including the County real estate taxes, and taxes for the years 1935 to 1943 were unpaid at the date of the sale to Snow [92, 93, 94].

All of the real property owned by the Corporation, except the Rolling Hills Subdivision was assessed by the County of Los Angeles and taxed on an acreage basis [156, 157, and Pltf. Ex. 9]. Since the Corporation acquired the Palos Verdes Rancho in 1926 it has never bought any other real estate [178]. During the period of its Corporate history it has only sold its own property and has never acted as a broker or development company for any other person [178]. All sales of acreage were made substantially in the condition in which the land was acquired by the Corporation [179].

During the year 1944 the Board of Directors of the Corporation passed resolutions evidencing the intention of the Corporation to sell approximately all of the remaining acreage of the Corporation [99, 100], and to liquidate and distribute the proceeds from the sale to the stockholders [101, 102, 103, 104].

Question Presented.

The sole question presented is as follows:

Is the gain on the sale of the unsubdivided portions of appellant's real property sold to Snow in the year 1944 taxable as ordinary income to the Corporation under the provisions of the Internal Revenue Code, or as a gain derived from the sale of a capital asset under the provisions of Section 117(a)(10) of the Internal Revenue Code, or as a gain from the sale of real estate used in the trade or business of the Corporation under the provisions of Section 117(j) of the Internal Revenue Code?

It is admitted that the Corporation is in the real estate business with respect to its subdivided property. A subsidiary question is then presented—can the Corporation be in the real estate business with respect to a portion of its real property and be an investor with respect to the remainder of its real property?

The Court, in its Findings of Fact found that the Corporation was engaged in the real estate business, both as to the subdivided and unsubdivided real property and concluded that the parcel of real property sold to Snow was not a capital asset, nor an asset used in the Corporation's trade or business, and that all the real property was held primarily for sale to customers in the ordinary course of its real estate business.

Statutes and Regulations Applicable.

INTERNAL REVENUE CODE:

Sec. 117. Capital Gains and Losses.

"(a) Definitions,—As used in this chapter—

"(1) Capital assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23(1), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;

"(2) Short-term capital gain.—The term 'short-term capital gain' means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing net income;

"(3) Short-term capital loss.—The term 'short-term capital loss' means loss from the sale or exchange or a capital asset held for not more than 6 months, if and to the extent such loss is taken into account in computing net income;

"(4) Long-term capital gain.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

"(5) Long-term capital loss.—The term 'long-term capital loss' means loss from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such loss is taken into account in computing net income;

"(6) Net short-term capital gain.—The term 'net short-term capital gain' means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year;

"(7) Net short-term capital loss.—The term 'net short-term capital loss' means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year;

"(8) Net long-term capital gain.—The term 'net long-term capital gain' means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year;

"(9) Net long-term capital loss.—The term 'net long-term capital loss' means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

"(10) Net capital gain.—

"(A) Corporations.—In the case of a corporation, the term 'net capital gain' means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges; and

"(B) Other Taxpayers.—In the case of a taxpayer other than a corporation, the term 'net capital gain' means the excess of (i) the sum of the gains

from sales or exchanges of capital assets, plus net income of the taxpayer or $1,000, whichever is smaller, over (ii) the losses from such sales or exchanges. For purposes of this subparagraph, net income shall be computed without regard to gains or losses from sales or exchanges of capital assets. If the tax is to be computed under Supplement T, 'net income' as used in this subparagraph shall be read as 'adjusted gross income.'

"(11) Net capital loss—The term 'net capital loss' means the excess of the losses from sales or exchanges of capital assets over the sum allowed under subsection (d). For the purpose of determining losses under this paragraph, amounts which are short-term capital losses under subsection (e)(1) shall be excluded.

"(b) Percentage Taken Into Account.—In the case of a taxpayer other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

"100 per centum if the capital asset has been held for not more than 6 months;

"50 per centum if the capital asset has been held for more than 6 months."

"* * * * * * * * *"

Internal Revenue Code:

"Sec. 117. Capital Gains and Losses.

"* * * * * * * * *"

"(j) Gains and Losses from Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

"(1) Definition of property used in the trade or business.—For the purposes of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k)(1) or (2) is applicable.

"(2) General rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

"(A) In determining under this paragraph whether gains exceed losses, the gains and losses de-

scribed therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

"(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion. "* * *"

Treasury Regulations 111, Sec. 29.117-1 (as amended by T. D. 5425, Dec. 29, 1944):

"Meaning of terms.—The term 'capital assets' includes all classes of property not specifically excluded by section 117(a)(1). In determining whether property is a 'capital asset', the period for which held is immaterial.

"The exclusion from the term 'capital assets' of property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 23(1) and of real property used in the trade or business of a taxpayer is limited to such property used by the taxpayer in the trade or business at the time of the sale, exchange, or involuntary conversion. Gains and losses from the sale or exchange of such property are not subject to the percentage provisions of section 117(b) and losses from such transactions are not subject to the limitations on losses provided in section 117(d), except that under section 117(j) the gains and losses from the sale or exchange of such property held for more than 6 months may be treated as gains and losses from the sale or exchange of capital assets, and may thus be subject to such limitations. See section 29.117-

7. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term 'capital assets' even though depreciation may have been allowed with respect to such property under section 23(1) prior to its amendment by the Revenue Act of 1942. However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the limitations of section 117(b), (c) and (d). The term 'ordinary net income' as used in these regulations for the purposes of section 117 means net income exclusive of gains and losses from the sale or exchange of capital assets.

"* * *

"In the definition of 'net short-term capital gain', as provided in section 117(a)(6), the amounts brought forward to the taxable year under section 117(e) are short-term capital losses for such taxable year.

"Gains and losses from the sale or exchange of capital assets held for not more than six months (described as short-term capital gains and short-term capital losses) shall be segregated from the gains and losses arising from the sales or exchanges of such assets held for more than six months (described as long-term capital gains and long-term capital losses). The percentage brackets of section 117(b) have no application to corporations, corporate gains and losses being taken into account to the full extent, without regard to the length of time the capital assets are held

(though because of the limitations in section 117(d) such losses may not be deductible in full).

"Section 117(a)(10) defines 'net capital gain'. In the case of a corporation the term 'net capital gain' means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges which losses include any amounts brought forward under section 117(e). In the case of a taxpayer other than a corporation the term 'net capital gain' means the excess of (1) the sum of the gains from sales or exchanges of capital assets, plus net income (computed without regard to gains and losses from sales or exchanges of capital assets) of the taxpayer or $1,000, whichever is smaller, over (2) the losses from such sales or exchanges, which losses include amounts brought forward under section 117(e). For taxable years beginning after December 31, 1943, in the case of a taxpayer whose tax liability is computed under Supplement T, the term 'net income', as used in the preceding sentence, shall be read as 'adjusted gross income'. In the determination of adjusted gross income (prior to the determination of 'net capital gain') there shall be taken into account the same percentages of the gain or loss as are taken into account in computing net income. For application of the term 'net capital gain', in computing the capital loss carry-over under section 117(e), see section 29.117-2(c).

"Section 117(a)(11) defines 'net capital loss' to mean the excess of the losses from sales or exchanges of capital assets over the sum allowed under section

117(d). However, amounts which are short-term capital losses under section 117(e)(1) are excluded in determining such 'net capital loss'.

"* * *"

Treasury Regulations 111, Sec. 29.117-2 (as amended by T .D. 5425, Dec. 29, 1944).

"Percentage of capital gain or loss taken into account: Net loss carry-over.—(a). General.—In computing the net income of a taxpayer, other than a corporation, the amount of the gain or loss, computed under Section 111 and recognized under Section 112, upon the sale or exchange of a capital asset shall be taken into account only to the extent provided in Section 117(b). The percentage of the gain or loss to be taken into account ranges from 100 percent to 50 percent, depending upon the period for which the asset was held. For instance, if unimproved real estate purchased by an individual for $20,000 is a capital asset and is sold by him for $25,000 after having been held for more than six months, only 50 percent of the recognized gain ($5,000), or $2,500, shall be taken into account in computing net income; or if such property is sold for $14,000, only 50 percent of the recognized loss ($6,000), or $3,000, shall be so taken into account.

"(b) Limitation on Capital Losses.—Section 117 (d)(1) provides that, in the case of a corporation, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of the gains from such sales or exchanges, and section 117

(d)(2) provides that, in the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed as a deduction only to the extent of the gains from such sales or exchanges, plus net income (computed without regard to such gains or losses) of the taxpayer or $1,000, whichever is smaller. Thus, where an individual taxpayer, having an ordinary net income of $5,000, has a net long-term capital loss of $4,000, of which $2,000 (50% of $4,000) is taken into account, the net loss of $2,000 is allowable only to the extent of $1,000, the remaining $1,000 being an unallowable deduction. If the taxpayer's ordinary net income, computed without capital gains and losses, had been $400 instead of $5,000, only $400 of the net loss of $2,000 would have been allowed, giving the taxpayer no taxable income and an unallowable capital loss of $1,600. (For disposition of the unallowable capital loss, see subsection (c) of this section.) However, in the case of banks, as defined in section 104, the limitation under section 117(d)(1) is modified by section 117(i) so that the excess of any losses of the taxable year from sales or exchanges of bonds, debentures, notes or certificates, or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof) with interest coupons or in registered form, over gains of the taxable year from such sales or exchanges may be deductible in full as an ordinary loss. In case the tax is computed under Supplement T, the term 'net income' shall, for taxable years beginning after

December 31, 1943, be read as 'adjusted gross income.'

"* * *."

Treasury Regulations 111, Sec. 29-117-7 (as amended by T. D. 5394, July 27, 1944).

"Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business.—Section 117(j) provides that the recognized gains and losses

"(a) From the sale, exchange, or involuntary conversion of property used in the trade or business of the taxpayer at the time of the sale, exchange, or involuntary conversion, held for more than six months, which is

"(1) of a character subject to the allowance for depreciation provided in section 23(1), or

"(2) real property,

provided that such property is not of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or is not held by the taxpayer primarily for sale to customers in the ordinary course of trade or business and

"(b) from the involuntary conversion of capital assets held for more than six months, and

"(c) from timber held for more than six months which is considered to have been sold under the provisions of section 117(k)(2), and with respect to taxable years beginning after December 31, 1943, from timber owned or held

under a contract right to cut for more than six months prior to the beginning of the taxable year which is considered to have been sold or exchanged under the provisions of section 117 (k)(1), regardless of whether such timber would be properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or whether such timber was held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,

shall be treated as gains and losses from the sale or exchange or capital assets held for more than six months if the aggregate of such gains exceeds the aggregate of such losses. If the aggregate of such gains does not exceed the aggreate of such losses, such gains and losses shall not be treated as gains and losses from the sale or exchange of capital assets.

"In determining whether such gains exceed such losses for the purposes of section 117(j), losses upon the destruction in whole or in part, theft or seizure, requisition or condemnation of the property described in section 117(j) are included whether or not there was a conversion of such property into money or other property. For example, if a capital asset held for more than 6 months, with an adjusted basis of $400. is stolen, and the loss from this theft is not compensated for by insurance or otherwise, the $400 loss is included in the computations under section 117(j) to determine whether gains exceed losses. Furthermore, in making this computation, the gains and losses described in section 117(j) are taken into account without regard to the percentage provisions of section 117(b), that is, 100 percent of such gains and losses is taken into account. For example, if a taxpayer sustains a loss of $400 upon the sale under

threat of condemnation of a capital asset, held for more than 6 months, such loss is taken into account for the purposes of section 117(j) to the extent of $400, even though only $200 would be taken into account under section 117(b) in computing net income. Similarly, the provisions of section 117(d) limiting the deduction of capital losses are not applicable to exclude any losses from the computations under section 117(j). With these exceptions as to sections 117(b) and 117(d), gains and losses are included in the computations under section 117(j) only to the extent that they are taken into account in computing net income. Thus, losses which are not deductible items under section 24 or section 118 are not included in the computations under section 117(j). Similarly, if a taxpayer reports on the installment basis under section 44 the gain on the sale of property described in section 117(j), only the portion of the gain reported under section 44 in computing net income for the taxable year is included in the computations for such taxable year under section 117(j). Any gains and losses which are not recognized under section 112 are not included in the computations under section 117(j). Thus, if property is involuntarily converted into similar property, so that the gain on such conversion is not recognized under the provisions of section 112(f), such gain is not included in the computations under section 117(j).

"If it is determined under the above computations that the gains exceed the losses, all of such gains and losses are treated as gains and losses from the sale or exchange of capital assets held for more than 6 months. All such gains and losses are then subject to the limitations of section 117(b), (c), and (d), relating to the percentage taken into account, the alternative tax in the case of capital gains and losses,

and the extent to which capital losses are allowed. If it is determined under the above computations that the gains do not exceed the losses, none of such gains and losses are treated as gains and losses from the sale or exchange of capital assets. Such gains and losses are then not subject to the percentage limitations of section 117(b), and such losses are not subject to the limitations provided in section 117(d). For example, if the taxpayer during the taxable year has losses of $1,000 on the sale of certain depreciable machinery used in his trade or business, held for more than 6 months, and a gain of $400 on the sale under threat of condemnation of a capital asset held for more than 6 months, such losses exceed such gain, and such losses and gain are not treated as losses and gain from the sale or exchange of capital assets. The gain on the sale of the capital asset would therefore be taken into account in full, instead of to the extent of 50 percent as provided in section 117(b).

"Section 117(j) does not apply to gains and losses on the sale, exchange, or involuntary conversion of any property which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or which is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, but not including as such property timber which is considered to have been sold or exchanged as provided in section 117(k)(1), or which has been sold as provided in section 117(k)(2). The involuntary conversion of property described in section 117(j) is the conversion of such property into money or other property as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof.

"* * *."

Specification of Errors

Article I.

The findings that plaintiff was engaged in the real estate busness in so far as they relate to its farm acreage and to the sales of its unsubdivided portions of its real property contained in Article XXIV of Findings of Fact [68], and that the plaintiff was continuously engaged in the sale thereof, contained in Article XXV of the Findings of Fact [68], were erroneous in that the evidence as a whole shows that said unsubdivided portions of the real property were held primarily as an investment, and for the production of income; that such sales as were made were in the orderly liquidation of the investment, and were not made in the ordinary course of the trade or business of real estate.

Article II.

The Conclusions of Law that the parcel sold to one Snow in July, 1944, was not a capital asset, nor a capital asset used in plaintiff's trade or business, contained in Article II of Conclusions of Law [68] were erroneous in that the evidence shows that said parcel was held as an investment [19] and for the production of income and, at the time of the sale, was used in the trade or business of farming and grazing [173, 174, 175, 176] by plaintiff and was not held *primarily* for sale in the ordinary course of trade or business of real estate.

Article III.

The fiindings that all sales of unsubdivided real property were subject to restrictions in the Deed preventing use of the property except for residential purposes contained in Article XVIII of the Findings of Fact [67] were erroneous in that the evidence shows that many of the sales of plaintiff's lands were for governmental [153,

154], commercial and business use [170, 171], and that no restrictions were placed in such deeds and only restrictions were placed in sales restricting the use for residential purposes where the same were deemed appropriate [181]. No such restrictions were placed in the deed to Snow [46 to 59, incl.].

Article IV.

The Findings that although plaintiff made 34 additional sales of unsubdivided property in the fiscal year ending September 30, 1944, which were reported as ordinary income it has not, at any time, contended that this acreage represented a capital asset contained in Article XXIX of the Findings of Fact [67] were erroneous in that the evidence shows that the plaintiff, at the time of the action, considered all sales of acreage and unsubdivided portions of its real property as the sales of capital assets and that an error was made in not including such sales in addition to the Snow sale in its claim for refund [179].

Article V.

The Conclusions of Law that plaintiff advertised all of its property for sale to the general public contained in Article I of the Conclusions of Law [68] were erroneous in that the evidence shows that the brochures and pamphlets issued by the plaintiff were primarily applicable to the Rolling Hills Subdivision and they only constituted general historical background and publicity with respect to the Palos Verdes Rancho which included the unsubdivided portions of its real property [Deft. Exs. A, A-1, A-2, A-3, A-4]; that only one sporadic effort of general public solicitation was shown in the year 1940 [114], and that there was no evidence of advertisement to the public in the accepted sense of real estate business advertising of its real property during the course of its corporate history.

Summary of Arguments.

The Rancho Palos Verdes, a working ranch, was acquired and held for a long period of time as an investment and for the production of income and is properly classifiable as a capital asset under the provisions of Section 117, Internal Revenue Code.

In order to stimulate the sales of farms, mineral properties and other capital assets Congress enacted the relief provisions contained in Section 117, Internal Revenue Code to permit such transactions to take place without fear of prohibitive tax otherwise resulting from the realization in one year of gains and profits earned over a period of time.

The Corporation's purpose was not to engage in the real estate business, but to liquidate its assets and distribute the proceeds thereof to its stockholders as soon as possible. The liquidation proceeded slowly by reason of factors beyond the control of the Corporation, but was done in the most orderly manner and method possible. The course of conduct of the Corporation towards its unsubdivided parcels embraced nothing more than activities incidental to an orderly liquidation thereof.

Forced by economic necessity the Corporation went into the real estate business in 1936 as to a small portion of its real property which became known as the "Rolling Hills" development, but continued its policy of liquidation with respect to the remaining portions thereof. From such time on it acted in a dual capacity, *i. e.*, as a dealer as to its improved, subdivided, and developed portions and as an investor with respect to the remainder. The remainder, portions of which included the real property sold to Snow in the year 1944, was farmed, mined, and grazed for the production of income by the Corporation as an investor.

ARGUMENTS.

I.

Rancho Palos Verdes Was Acquired Originally as an Investment, a Capital Asset for the Production of Income, and in This Status the Corporation Acquired and Held the Real Property Herein Involved.

Although the record is unsatisfactory as to the subjective intent of the members of the Palos Verdes Syndicate upon acquisition of the Rancho Palos Verdes in 1913, as all of the members of the Syndicate were deceased at the time of the trial, except one, who was very aged and outside of the State of California [79, 80], the objective facts as to what the Syndicate did with the real property and what the Corporation did with this real property clearly show that the acquisition was for the purpose of investment, and not for the purpose of engaging in the development and sale of real property. It appears that the Syndicate held title to the real property for some ten (10) years before any sale was made, during which time it appointed a General Manager and engaged solely in farming activities [63, 64]. The Syndicate entered into a contract for the sale of the whole Rancho in the condition in which it was acquired in 1923 [83].

Holding an asset for many years indicates an intention to hold for investment rather than for sale. (*The Merchants National Bank of Mobile v. Commissioner* (1950), 14 T. C. 1375, 1379.)

The long period of holding assets without being disposed of violates the concept of an organized business with respect thereto. (*Mackall v. Commissioner* (1944),

3 T. C. M. 701; *Loewenberg v. Commissioner* (1948), 7 T. C. M. 702)

After failure to consummate the sale of the whole Rancho, the real property was transferred to the Corporation by the Syndicate as a more convenient vehicle for holding title in exchange for the issuance of stock [18]. The reasons for the formation of the Corporation were as stated by the Chairman of the Board of Directors of the Palos Verdes Corporation in answer to the question "Could you tell me the reasons for the formation of the Corporation at that time?" Answer "Well, as I knew them, they were that the property had been held by a Syndicate which was a very loose form particularly as to the administration of the property and, in the meantime, since the Syndicate had been formed, one or more of the original Syndicate members had died; whereupon estates were involved in the administration, and it had seemed to me at that time, and in which Mr. Vanderlip concurred and approved, that the matters should be incorporated for the usual purposes of incorporating a matter of that kind" [85, 86].

Not until approximately 1936, ten (10) years after acquisition by the Corporation, was any portion of the real property subdivided, developed and sold in a real estate business sense, and at that time only a relatively small portion of the Palos Verdes Rancho (approximately 600 acres) was subdivided and developed and became known as the "Rolling Hills" development [92, 93]. This subdivision was the result of a desire upon the part of the Corporation to take some rough and unproductive land not suitable for farming off the tax roll and to produce some funds to enable the Corporation to continue to hold the Rancho through the depression [93].

The parcel of real property sold to Snow was held by the Corporation for eighteen and one-half (18½) years before sale [18, 19].

A hope when a purchase of real property is made, that the property may, at some future time, be sold at a profit, will not transmute a long time investment in land into the business of buying and selling real estate, or change a capital transaction into an ordinary profit or loss. (*Harris v. Commissioner* (1944), 143 F. 2d 279.)

II.

The Intent of Congress in Enacting the Relief Provisions Provided in Section 117 Internal Revenue Code Is Thwarted, Negated and Rendered Meaningless by the Commissioner's Treatment of the Gains Derived From the Sales of Farm Acreage by the Corporation as Ordinary Gains. The Commissioner Has Erroneously Treated the Gain Resulting From the Snow Sale as All Having Occurred in the Year 1944, Whereas the Appreciation in Value Occurred Over a Long Period of the Holding of the Asset and Cannot Be Reasonably Attributed to Any One Year, or to the Corporation Activities With Respect to the Land.

Prior to 1921, the sale and exchange of property was treated, with respect to gains and losses, without differentiation from gains and losses incurred in connection with the business in general. The original step in limiting the taxation of gains resulting over a long period of time was contained in Section 206(b) of the Revenue Act of 1921. The purpose of the capital gains provisions embodied in such Act was set forth in House Report No. 350, 67th Cong., 1st Sess., as follows:

Capital Gain and Capital Loss.

Section 206: The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section (207) to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would under the ordinary procedure, be subjected to an income tax in excess of 15 per cent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 per cent is also applied to capital losses. Under present conditions they are likely to be more losses than gains.

Also in Senate Report No. 275, 67th Cong., 1st Sess., as follows:

Capital Gain and Capital Loss.

Section 206 limits the rate of taxation upon gain derived from the sale of capital assets. Under the present law many sales of farms, mineral properties, and other capital assets have been prevented by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum and the amount of surtax excessively enhanced thereby. In order to permit such

transactions to take place without fear of prohibitive tax, Section 206 provides that only 40 per cent of the net gain derived from the sale or other disposition of capital assets shall be taken into account in determining the net income upon which the income tax is imposed. This automatically reduces the rate of taxes applicable to such income by 60 per cent. The maximum rate (normal and surtax) upon ordinary income after January 1, 1922, will be 40 per cent, and the maximum rate applicable to capital net gain will be 16 per cent. The house bill placed a similar limitation upon both capital gains and losses, but this limitation was not applicable to corporations nor to certain classes of taxpayers having net income less than $29,000. The senate provision would permit a taxpayer to deduct the entire loss sustained in a capital transaction and is applicable to all classes of taxpayers. In Great Britain capital gain or loss is ignored or eliminated in computing the net income. Section 206 takes an intermediate position between the extreme views embodied, respectively, in the present American and British laws.

Judicial recognition of this purpose is set forth in the case of *Burnet v. Harmel* (1932), 53 S. Ct. 74, 287 U. S. 103, 77 L. Ed. 199, where the Court on pages 202-203 of L. Ed. said:

> "Before the Act of 1921, gains realized from the sale of property were taxed at the same rates as other income, with the result that capital gains, often accruing over long periods of time, were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provisions of the 1921 Revenue Act for taxing capital gains at a lower rate, reenacted in 1924 with-

out material change, were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions. House Report No. 350, Ways and Means Committee, 67th Cong., 1st Sess. on the Revenue Bill of 1921, P. 10; see *Alexander v. King* (C. C. A. 10th), 74 A. L. R. 174, 46 F. 2d 235."

Again in 1940, in the case of *Kenan, Jr. v. Commissioner of Internal Revenue* (1940), 114 F. 2d 217, the same purpose is alluded to in the opinion of the Court at page 220 as follows:

"(4) The purpose of the capital gains provisions of the Revenue Act of 1934 is so to treat an appreciation in value, arising over a period of years but realized in one year, that the tax thereon will roughly approximate what it would have been had a tax been paid each year upon the appreciation in value for that year. *Cf. Burnet v. Harmel,* 287 U. S. 103, 106, 53 S. Ct. 74, 77 L. Ed. 199. The appreciation in value in the present case took place between 1917 and 1935, whereas the Commissioner's theory would tax it as though it had all taken place in 1935."

See also:

Commissioner v. Shapiro (1942), 125 F. 2d 532.

In 1942, subsection (a), paragraphs (10 and 11), were added to Section 117 of the Internal Revenue Code, Act of 1942 (Act of October 21, 1942, C. 619, Stat. 798), Section 150 thereof, making the capital gain provisions thereof applicable to Corporations.

III.

The Primary Purpose of the Corporation in Holding the Rancho Palos Verdes Was to Liqudate It and, During Liquidation, Derive Income From Its Farming Activities, Not to Engage in the Business of Development, and of Buying and Selling Real Property.

It is well established that a casual sale of real estate held for an investment results in a capital gain or loss (*Phipps v. Commissioner* (1931), 54 F. 2d 469; *Snell v. Commissioner* (1938), 97 F. 2d 891; *Fahs v. Crawford* (1947), 161 F. 2d 315.)

Merely disposing of investment assets at intermittent intervals, without more, is not engaging in business, even though some preliminary effort is necessary to render the asset saleable. (*Fahs v. Crawford* (1947), 161 F. 2d 315; *White v. Commissioner* (1949), 172 F. 2d 629.)

The Corporation, from its inception, endeavored to sell the whole of its real property in the condition in which it acquired it from the Palos Verdes Syndicate [97, 143, 145, 179]. Its purpose was to liquidate its holdings and not to engage in the active conduct of a business. This purpose is formally exemplified in the year of the Snow sale, by the Resolutions of the Board of Directors of the Corporation contained in their Minutes of January 24, 1944 [99, 100], and July 31, 1944 [101, 102, 103, 104], authorizing the sale of all or substantially all of the property of the Corporation, and providing for the distribution in liquidation of the proceeds pro rata to the stockholders as their interests appear.

The efforts of the Corporation to sell its real property in the condition in which it acquired it, is not a trade or

business within the intendment of the tax statute. (*Croker v. Helvering* (1937), 91 F. 2d 299.)

The statute requires that in order to constitute a business, the property must not only have been held "primarily for sale" but also "for sale in the ordinary course of business of the taxpayer." (*Dunlap v. Oldham Lumber Co.* (1950), 178 F. 2d 781; 117(a)(1), Int. Rev. Code, Reg. 111, Sec. 29.117-1.)

The activities of the Corporation with respect to its unsubdivided acreage embraced nothing more than activities incidental to an orderly liquidation. (*Three States Lumber Co. v. Commissioner* (1946), 158 F. 2d 61.)

The sales of the Corporation's lands in acreage parcels were in an endeavor to get rid of capital assets which were not profitable to farm and produce further income, in view of the rising tax burden and the change of economic conditions in Southern California.

The liquidation progressed slowly not only because of the physical condition of the land and its enormous quantity, but because the demand for such real property encountered in the nationwide depression was very small. Until 1941, the sales were irregular, infrequent and lacking in continuity [168]. The increased sales of acreage parcels which occurred commencing with the year 1941, were the result of the increased demand for real property following the depression, and were not the results of real estate business activities of the Corporation. The Court will take judicial notice of a general rise or depression of real estate values as are a public concern which are known to all well-informed persons. (*Sleeper v. Zeiter*, 178 Minn. 622, 227 N. W. 662; *Dayton Power & Light Co. v. Public Utilities Commission*, 292 U. S. 290, 54 S.

Ct. 647; *Camerer v. California Bank,* 4 Cal. 2d 159, 48 P. 2d 39, 100 A. L. R. 667.)

During its entire corporate history, the Corporation bought no real property [178]. It merely tried to liquidate its holdings, selling first its fringe acres [173] and its unproductive lands [93] and endeavoring to hold the main body of the Ranch intact for a single sale [173] in liquidation.

IV.

The Course of Conduct of the Corporation with Respect to Its Acreage Land Did Not Establish Any Ordinary Course of Business, Such as Is Required Under the Tests Laid Down by the Courts to Convert Property Held for Investment Purposes and for the Production of Income, to Property Held Primarily for Sale in the Ordinary Course of Trade or Business.

Thrift, Sr. v. Commissioner, 15 T. C. 366.

See also:

Dunlap v. Oldham Lumber Co., 178 F. 2d 781;

U. S. v. Robinson, 129 F. 2d 297.

The Courts have pointed out that there is no one decisive test to determine whether real estate is held primarily for sale to customers in the ordinary course of business, or whether it is to be considered as a capital asset. The solution must depend upon all of the pertinent facts. Thus in the case of *Guthrie v. Jones* (1947), 72 Fed. Sup. 784, at p. 785, the Court said as follows:

> "A. The issue is whether the profits received from the sale of the taxpayer's lots were, under the

facts found, a sale of capital assets, only one-half of which profit may be subjected to income tax, or whether the profits from such sales arose from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business in which event the whole of the gain is subject to income tax as ordinary income. 26 U. S. C. A., Int. Rev. Code, Sec. 117. The issue is one of fact. *Reynolds v. Commissioner* 1 Cir., 155 F. 2d 620; *Van Suetendael v. Commissioner,* 2 Cir., 152 F. 2d 654; *Estate of Kleberg v. Commissioner,* 7 T. C. 1488; and see *Higgins v. Commissioner,* 312 U. S. 212, 61 S. Ct. 475, 85 L. Ed. 783; *Fuld v. Commissioner,* 2 Cir., 139 F. 2d 465.

(3) The existence of certain circumstances such as the regularity and continuity of sales (*Higgins v. Commissioner, supra; Brown v. Commissioner,* 5 Cir., 143 F. 2d 468), the nature of the acquisition of the property or purpose of acquisition (*Kanawha Valley Bank v. Commissioner,* 4 T. C. 252; *Thompson Lumber Co. v. Commissioner,* 43 B. T. A. 726; *Jones v. Commissioner,* 1 T. C. 1214; *Three States Lumber Co. v. Commissioner,* 7 Cir., 158 F. 2d 61, reversing 5 T. C. 1391), the nature and extent of taxpayer's 'Business' (*Flint v. Stone Tracy Co.,* 220 U. S. 107, 171, 318 (S. Ct. 342, 55 L. Ed. 389, Ann. Cas. 1912B, 1312) the activity of the taxpayer in promoting the sales (*Haden v. Commissioner,* 2 T. C. 1268; *Oliver v. Commissioner,* 1 T. C. 1215, affirmed 4 Cir. 138 F. 2d 910; *Swanston v. Commissioner,* 1 T. C. 1216), and other circumstances are the factors to be considered in arriving at a decision. No one of these facts is decisive but the solution must depend upon all the pertinent facts and their relative importance in each case."

It is to be noted in the above case that the taxpayer acquired by foreclosure a platted and subdivided addition to Oklahoma City in 1932. Until 1940, taxpayer made only a casual sale of a lot with the addition. Sales increased during the period of 1940 to 1943. There were 100 transactions from 1940 to 1942, 70 of which were unsolicited purchases made in 1940 and 1941, 24 sales for 1942, and 6 in which the sale was never completed. There were 113 transactions for 1943. There were 84 sales of lots for the tax years involved (1942-1943). Nevertheless, the Court held that the taxpayer's business was loans and investments, and not the real estate business; the property was acquired incident to the default of a loan; the sale of the lots acquired was made to regain the amount of the loan; the taxpayer was inactive and passive in the sales; the sales were irregular and lacking in continuity for eight (8) years; the bulk of the sales were due to the growth of the community and to changes in economic conditions; and the lots were not held primarily for sale; it followed that the profit from the sales were held to be long term capital gains, as distinguished from ordinary gains.

Ordinarily, in determining whether real estate is held for sale to customers, the most important test is whether the sales were frequent, or isolated and casual. (*Boomhower v. U. S.* (1947), 74 Fed. Sup. 997; *Trapp v. U. S.* (1948), 79 Fed. Sup. 320.)

In the following leading cases on the subject, great emphasis was placed upon the frequency and continuity of sales. (*Ehrman v. Commissioner* (1941, 120 F. 2d 607; *Brown v. Commissioner* (1944), 143 F. 2d 468; *Richards v. Commissioner* (1936), 81 F. 2d 369; *Snell*

v. Commissioner (1938), 97 F. 2d 891; *White v. Commissioner* (1949), 172 F. 2d 629; *Field v. Commissioner* (1949), 8 T. C. M. 170; *Oliver v. Commissioner* (1943), 138 F. 2d 910.)

The Frequency and Continuity Test Does Not Apply, However, When the Elements of Development and Substantial Sales Activity Are Lacking, and the Taxpayer Merely Accepts Satisfactory Offers From Unsolicited Purchasers.

Phipps v. Commissioner (1931), 54 F. 2d 469;

Frieda J. Farley v. Commissioner (1948), 7 T. C. 198;

Estate of Alice G. Kleberg (1946), 5 T. C. M. 858;

Claude M. Ferguson v. Commissioner (1950), 9 T. C. M. 243.

The quantum of sales must be viewed in the light of other circumstances. (*W. M. Foster v. Commissioner* (1943), 2 T. C. M. 595.)

Although the liquidation of investment test has been rejected in cases where the manner of conducting the alleged liquidation was such as to constitute a trade or business itself, see *Ehrman v. Commissioner* (1941), 120 F. 2d 607, and *Gruver v. Commissioner* (1944), 142 F. 2d 363, where the elements of development and sales activity are absent, the fact of liquidation is not to be disregarded.

(*White v. Commissioner* (1949), 172 F. 2d 629; *Frieda J. Farley v. Commissioner* (1948), 7 T. C. 198; *Viggo Gruy v. Commissioner* (1950), 9. T. C. M. 235.) In such instances, the purpose of acquisition is an important

factor to be regarded. (*R. H. Hutchinson v. Commissioner* (1949), 8 T. C. M. 597; *Ashton C. Jones, Jr. v. Commissioner* (1943), 1 T. C. M. 816; *William R. Watson v. Commissioner* (1947), 6 T. C. M. 772; *Donald J. Powers v. Commissioner* (1941), Par. 41,498 P. H. Memo. T. C.; *Roy L. Self v. Commissioner* (1950), 9 T. C. M. 421.)

There is a line to be drawn between those who take the position of passive investors, doing only what is necessary from an investment point of view, and those who associate themselves actively in enterprises in which they are financially interested, and devote a substantial part of their time to that work as a matter of business. (*Fahs v. Crawford* (1947), 161 F. 2d 315; *Kane v. Commissioner* (1938), 100 F. 2d 382.)

The following evidentiary matter discloses the passivity and lack of real estate sales activity with respect to the acreage parcels:

(1) No "For Sale" signs were placed on portions of the Rancho outside the Rolling Hills project [95, 172].

(2) Property not listed with outside brokers [95].

(3) Except in connection with the sale of the whole remaining portions of the Rancho in 1944, no prices were ever fixed in advance on acreage parcels [95].

(4) Sales were made upon inquiries of purchasers [95].

(5) No improvements made upon acreage parcels prior to sale [95].

(6) No real estate offices on acreage parcels [96, 173].

(7) No real estate brokers employed in connection with the sales of acreage [96].

(8) No portions of the Rancho were platted out for subdivision purposes or improvements made in connection with the sales [142, 171, 172].

(9) Irregularity and lack of continuity of sales [168]. In a number of years no sales were made [168]. During a number of years only a single sale was made [168].

(10) No continuous activity of buying and selling real property [170].

V.

The Fact That the Corporation Operated Under a Charter That Gave It the Power to Act as a Dealer, Broker or Speculator in Real Estate, Did Not Preclude Its Holding Land for Investment and the Production of Income.

In the case of *Loughborough Development Corporation v. Commissioner* (1933), 29 B. T. A. 95, at p. 98, the Court stated as follows:

> "The fact that the petitioner operated under a charter that gave it the power to act as a dealer, broker or speculator in real estate, in our opinion, did not prevent it from acquiring and holding real estate 'for investment' and not 'primarily for sale,' although such property may have been acquired with the intention of selling or disposing of the same

at some subsequent, though not early, date and would not otherwise have been acquired."

See also:

Winter Holding Corporation v. Commissioner (1935), 31 B. T. A. 1185.

The Bureau of Internal Revenue has long recognized that a real estate dealer may also be a real estate investor. See I. T. 2297, C. B. v-2 (1926), p. 109, at page 10 as follows:

"It is evident that the real property regularly bought and sold by a real estate dealer is property held primarily for sale. By the express provisions of section 208(a) 8 of the Revenue Act of 1924, such property could not become capital assets even if held by the taxpayer for more than two years.

"However, if a dealer can establish that any of the property sold by him was held primarily for investment rather than for sale, the provisions of section 206(b) of the Revenue Act of 1921 and section 208(b) of the Revenue Act of 1924 will apply to the taxation of the profits realized from the sale thereof."

See also:

I. T. 2555, C. B. X-1, p. 306 (1931).

The difficulty is that in practice the Bureau of Internal Revenue is rarely convinced that the taxpayer is acting in the dual capacity. The problem is not unique to real estate. The Bureau has faced it squarely in the case

of security dealers—in fact, has held that security dealers could also invest in securities and obtain a capital gain on sale. I. T. 2502, C. B. VIII-2 (1929), p. 128; I. T. 3828, C. B. 2 (1946), p. 68. See also *Van Suetendael v. Commissioner* (1945), 152 F. 2d 654. Recently the Court found and ruled that the investment securities could even be of the same type or nature as those ordinarily sold to the dealers' customers. I. T. 3891, C. B. 1 (1948), p. 69.

The Courts also have held that a taxpayer may hold certain property for sale to customers in the ordinary course of business, and other property of a similar character as an investment. (*Farry v. Commissioner* (1949), 13 T. C. 8; *Ashton C. Jones, Jr. v. Commissioner* (1943), 1 T. C. M. 816; *George J. Wibbelsman v. Commissioner* (1949), 12 T. C. 1022; *Vaughan v. Commissioner* (1936), 85 F. 2d 497; *Fuld v. Commissioner* (1941), 44 B. T. A. 1268; *Stamler v. Commissioner* (1944), 145 F. 2d 37; *E. Everett Van Tuyl v. Commissioner* (1949), 12 T. C. 900; *Hammitt v. Commissioner* (1935), 79 F. 2d 494; *Francis Shelton Farr v. Commissioner* (1941), 44 B. T. A. 683; *R. O. Holton & Co. v. Commissioner* (1941), 44 B. T. A. 202.)

In the following cases, a distinction has been made between the sales of subdivided lands, which were treated as ordinary gains, and the sales of unsubdivided lands, both held by the taxpayer, which are treated as capital gains. (*J. O. Chapman v. Commissioner* (1944), 3 T. C. M. 604; *Alexander Weil v. Commissioner* (1944), T. C. M. 528.)

VI.

The Parcel of Real Property Sold to Snow During the Fiscal Year Ending September 30, 1944, Is Also Properly Classified as a Section 117(j) Asset.

See 28 U. S. C. A., Sec. 117(j), and Regulation 111, Sec. 29.17-7 as amended by T. D. 5394, July 27, 1944.

The parcel sold to Snow was used by the Corporation prior to and at the time of the sale in connection with its farming activities [174, 175, 176, 177, 178]. At the time of the sale to Snow it was actually under lease as to the tillable areas [175], and was in use for the production of income as to the non-tillable areas for grazing [177, 178].

Although for the purposes of this action it makes no difference whether the real property sold to Snow is classified as a "capital asset" within the meaning of Section 117(a) I. R. C., or an asset used in taxpayer's trade or business, within the meaning of Section 117(j) I. R. C. (in both instances any gains derived from the sale thereof is a capital gain and limited to a tax of twenty-five per cent (25%) this real property can be properly classified as real property used in taxpayer's trade or business of leasing and farming. (*Fackler v. Commissioner of Internal Revenue* (1943), 133 F. 2d 509.)

Following the *Fackler* case, a long line of decisions of the Tax Court, some of them acquiesced in or conceded by the Commissioner, has followed the rule that ownership of any income producing real property is a trade or business within the meaning of Section 117, even though taxpayer is engaged in some other business upon a full time basis and devotes a negligible amount of attention to the real property. The rule above mentioned has been applied to property purchased for an investment. (*Wright,*

Jr. v. Commissioner (1947), 9 T. C. 173; *Jamison v. Commissioner* (1947), 8 T. C. 173; *McKean v. Commissioner* (1946), 6 T. C. 757; *Hazard v. Commissioner* (1946), 7 T. C. 372. See also, *Claude M. Ferguson v. Commissioner* (1950), 9 T. C. M. 243; *Farry v. Commissioner* (1946), 13 T. C. 8; *Harris v. Commissioner* (1941), 44 B. T. A. 999; *Ben L. Carroll v. Commissioner* (1930), 21 B. T. A. 724.)

Conclusion.

The long period of holding of the real property sold to Snow and its use for the production of farm income without being disposed of and without subdivision, development or improvement, violates the concept of an organized real estate business with respect thereto. The appreciation in value of such asset cannot reasonably be attributed to any one particular year, or to the activities of the taxpayer with respect thereto, but can only be attributed to the growth, development and the change in economic conditions in Southern California which took place over the long holding period of this asset. To tax such gain as if all such appreciation in value had occurred in the year 1944 would negate and render meaningless the relief provisions enacted by Congress to encompass just such a precise situation. To tax such sale as a capital gain would best exemplify the fundamental provisions enacted by Congress limiting the taxation of capital gains.

Respectfully submitted,

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